

Keeping SR&ED in Mind

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Darren Speake, CA

- Senior Tax Manager, SR&ED Practice

darren.speake@ca.pwc.com, 416-869-2471

About the Canadian Scientific Research and Experimental Development (“SR&ED”) Tax Credit Program

- Tax incentive program to encourage Canadian businesses to conduct R&D leading to new or improved technologically advanced products or processes
- The R&D tax credit program is very stable and provides credits in excess of \$4 billion to Canadian industry annually
- One of the most generous in the world.
- No restrictions on owning Intellectual Property.
- No advanced approval required.
- Expenditures are captured net of government funding.

Categories of SR&ED

- A. Basic research
- B. Applied research
- C. Experimental development (most claims)
- D. Support Work (related to A, B or C)
 - design
 - engineering
 - computer programming
 - mathematical analysis
 - operations research
 - psychological research
 - testing
 - data collection

Experimental Development:

“Work undertaken for the purposes of achieving technological advancement for the purposes of creating new, or improving existing materials, devices, products or processes, including incremental improvements”

SR&ED does not include:

- Market research or sales promotion
- Quality control or routine testing
- Commercial production
- Style changes
- Routine data collection

When does R&D = SR&ED?

Eligibility Criteria

- Scientific or technological **advancement**
 - Gained know-how/knowledge that increases company's knowledge or technical base
- Scientific or technological **uncertainty**
 - Challenge that cannot be solved with in-house know-how or existing/available knowledge/technology
- Scientific **approach**
 - Approach to solving uncertainty has to be systematic, experimental plans and supporting **documentation**

all three criteria must be met

Indicators of SR&ED in Software Projects may include:

- Customization of software where there were performance problems
- Performance issues with on-line systems
- Interfaces to legacy databases
- Complicated data imports/migrations
- Permissions and Security issues
- Any project that ran longer than planned or was significantly over budget
- IT projects that required more computing power or data storage than was originally anticipated
- Integration of systems across the corporate group

Research and Development Benefits

Federal Investment Tax Credit program:

- CCPC - 35% refundable (must meet size & income tests)
- Non-CCPC - 20% non-refundable (can be carried back 3 years forward 20)
- Capital expenditures are currently deductible
- All expenditures can be carried forward indefinitely for later deduction

Research and Development Benefits

Ontario:

- 10% refundable (OITC) (must meet size & income tests)
 - Group taxable capital between \$25m and \$50m
 - Group taxable income between \$400k and \$700k
 - Non-CCPC's are eligible
- 4.5% non-refundable credits for taxation years ending after Dec. 31, 2008.
- 20% refundable (OBRI) – Ontario Business Research Institute
- Ontario Interactive Digital Media Tax credit (“OIDMTC”)
 - Interactive digital media that educates, informs or entertains.
 - Two of text, sound, imaged; interactive for individual user

Other Provinces

- All provinces other than PEI offer a provincial SR&ED ITC

Canadian Controlled Private Corporation “CCPC”

- A corporation that is NOT controlled by non-residents or a public company (or combination)
- Control for purposes of CCPC definition include voting control but also takes into account:
 - Control of Board of Directors
 - Defacto control
 - Expenditure limit must be shared among associated companies.

SR&ED – New Phase-out Ranges

Increase in annual expenditure limit and the taxable income and capital phase-out ranges for CCPCs (for taxation years ending after February 25, 2008):

		Old	New
Annual expenditure limit:		\$2 million	\$3 million
Phase-out range:	Taxable income	\$400,000 to \$600,000	\$400,000 to \$700,000
	Taxable capital	\$10 million to \$15 million	\$10 million to \$50 million

SR&ED – Refundable Federal ITCs

	Investment tax credit rate	Refund rate
Qualifying CCPC:	<p>35% of annual expenditures up to threshold (\$3M or less)</p> <p>+ 20% of qualified expenditures not eligible for the 35% rate</p>	<p>100% of ITCs on current expenditures computed at 35%</p> <p>+ 40% of ITCs on capital expenditures computed at 35% plus all ITCs computed at 20%</p>
Other Corporations:	20%	N/A

Qualifying SR&ED Expenditures

- Salaries of personnel directly engaged in SR&ED
- Materials
- New capital equipment actually used all or substantially all (or intention to use all or substantially) in the prosecution of SR&ED
- Leased equipment used all or substantially all for SR&ED
- Certain contract payments
- Certain incremental overhead expenditures (or proxy)

Proxy vs. Actual Overhead

Overhead

One of two methods can be chosen:

- Traditional Method (actual incremental and directly related overhead)
 - Rent/building costs not eligible
- Proxy Method
 - No claim for actual overhead expenditures
 - Proxy = 65% x Base Salary Amount
 - SR&ED salaries, **less bonuses and certain taxable benefits**

Illustration – ITCs generated by CCPC on Salaries

Qualifying Salaries:	1,000,000	
Overhead (PROXY method)	<u>650,000*</u>	
Total qualifying expenditures	1,650,000	
Federal Credit (35%)	493,763	
Ontario Credit (10%)	<u>165,000</u>	
Cash Refund	658,763	
Ontario Credit (4.5%) Credit**	<u>74,250</u>	
Total ITCs generated	<u>733,013</u>	<u>73%</u>

* May be limited

** For taxation years ending after December 31, 2008

Maximizing SR&ED

- Designing effective incentive compensation:

For example (CCPC rates):

- Salary \$100 = \$73.30 ITC
- Bonus \$100 = \$44.40 ITC
- Stock Option \$100 = \$0 ITC

- Pay salary to shareholder that was involved in SR&ED?*
- Contractor vs. Employee (\$44.40 ITC vs. \$73.30 ITC)
- New versus used equipment
- Prior year income levels – bonus down
- Association with other companies or investors
- Overhead costs – proxy vs. traditional
- Non-resident contractors
- Work done outside Canada

* May be subject to specified shareholder rules

Preparing & Filing SR&ED Claims

Project Management:

- Identify projects with potential SR&ED qualifying expenditures
- Review projects and assess SR&ED eligibility
- Identify amount of qualifying expenditures for eligible projects
- Prepare technical report for each project
- Prepare prescribed tax forms – T661 and schedule 31
- File on timely basis
- Manage SR&ED audit

Recommendations:

- Assign responsibilities
- Adequate training/understanding of benefits to company
- Consider time keeping system
- Check points throughout the year and deadlines
- Include in staff annual goals
- Ensure good communication between technical staff and finance staff

Timely Filing

- Statute-barred 18 months after year-end!
- Assume company with December 31, 2007 year end
- Normal tax return due date is June 30, 2008
 - CRA processing commitment = 120 days
- Extended due date is June 30, 2009
 - CRA processing commitment – 240 days
- Refund delay can be up to 16 months!
- Consider outsourcing vs. internal resources
- Financing available
- Non-CCPC-365 day turn around

Current Issue: Increased Demand for Documentation

Audit Experience: Increased emphasis on supporting documentation

- Project team members: Who are they, what did they do, show me evidence
- Documentation: e.g. test plans, experimental data, analysis of results dates

First time claimants

- CRA is generally lenient with “first timers” – they understand challenge for smaller organizations to maintain historical records, document control systems
- BUT....you can only be a first time claimant once
- Claimant needs to make an effort to incorporate CRA suggestions for improvement

Recommendations

- Increase awareness: employees who do SR&ED are best able to support claim
- Create audit binder: Identify and collect documents throughout the year
- Project descriptions: Cite specific documents instead of generic references

Examples of technical documentation – (Source: CRA)

- Background information searches
- Consultations with experts.
- Experimental plans
- Memo's, e-mails indicating conception of a project
- Process flow charts
- Laboratory tests and note books
- Notes describing outcomes of trials, next steps taken, interpretation of findings
- Memo's, report detailing experimental findings
- Engineering drawings or prototype sketches
- Any dated documentation that can demonstrate that the work performed involved conception of a project, experimentation and interpretation of findings

Project Descriptions

- Focus on technology not business requirements or features or marketing jargon when preparing job descriptions
- Use the CRA's format (5 sections) for project descriptions
- Appropriate level of detail
- Focus on problems and how they were resolved
- Pre-claim project review ("PCPR")?

Summary

- Be proactive – think about SR&ED throughout the year
- Project management
- Document, document, document
- Consider account executive

Role of SR&ED consultant

- Can train your staff during the year
- SR&ED criteria broad and subject to interpretation - can access activities in order to maximize claim
- Prepares technical reports in the proper format and terminology that the CRA expects
- Can prevent errors which can increase risk of audit
- Saves valuable lead developer time
- Experience in dealing with SR&ED audits
- Can leverage our relationships with the CRA

Thank you.

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